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Non-discretionary conservatism: Evidence and implications☆,☆☆

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ABSTRACT

A large body of accounting research finds that various contracting incentives lead managers to engage in conservative accounting practices. We extend existing research by modeling the impact of extant accounting rules on conservative accounting. Accounting rules typically require assets to be written down when their fair values drop sufficiently below their book values. We document evidence of the resulting non-discretionary conservatism and show that it appears to explain some of the results from previous research on contracting incentives.

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1. Introduction

Conservatism is a prevalent feature of Generally Accepted Accounting Principles (GAAP). A prime example is the requirement that most non-financial assets must be written down when their fair values drop sufficiently below their carrying values, but generally cannot be written up when their fair values rise above their carrying values. Conservatism has also been a popular topic in recent academic research. A large body of literature documents that variables designed to capture various contracting incentives explain cross-sectional variation in conservatism.[1] For example, Ahmed et al. (2002, p. 868) argue that "firms experiencing more severe bondholder-shareholder dividend policy conflicts adopt more conservative accounting" and Nikolaev (2010, p. 138) argues that "when debt contracts rely on accounting based covenants, bondholders are likely to provide higher incentives for timely loss recognition to the firm's management and its auditors." Overall, this research concludes that accounting conservatism facilitates efficient contracting.

In this paper, we provide evidence on the role of GAAP in explaining cross-sectional variation in conservatism. In particular, we focus on the accounting rules requiring assets to be written down when their fair values drop sufficiently

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[1] For a more detailed review of the conservatism literature see Watts (2003a, 2003b), Ryan (2006), and Ruch and Taylor (2011).

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below their book values.[2] Previous research suggests that managers with certain contracting incentives voluntarily engage in conservative accounting (e.g., Ahmed et al., 2002, pp. 873–874) and that reputation and litigation costs enable managers to credibly commit to engage in more conservative accounting (e.g., Nikolaev, 2010, pp. 143–145). We provide evidence that compliance with GAAP is another mechanism through which conservative accounting facilitates efficient contracting.

Following Ahmed et al. (2002), we refer to conservatism that is required by accounting rules as non-discretionary conservatism. The accounting rules mandating conservatism generally involve subjectivity (e.g., estimating an asset's fair value). Thus, we formally define non-discretionary conservatism as conservatism resulting from the unbiased application of GAAP. We then define discretionary conservatism as conservatism arising from purposeful intervention in the financial reporting process to adjust the amount and timing of conservative accounting. We emphasize that the opportunity to exercise discretion arises because of subjectivity in GAAP. For example, the determination of the fair value of goodwill involves considerable subjectivity. Under such conditions, it is difficult for auditors and regulators to verify fair value estimates, and so management can trade off the expected benefits from exercising discretion versus the potential costs of violating GAAP. Since compliance with GAAP is required for continued listing on a securities exchange, we expect GAAP to be an important influence on observed accounting choices for exchange-listed companies.

Our empirical results are consistent with a significant role for non-discretionary conservatism. We show that asset write-downs are increasing in the beginning of period asset book-to-market ratios. We also show that the form of this relation is consistent with the provisions of GAAP related to asset write-downs. In particular:

(i) The relation is nonlinear, strengthening significantly for beginning of period asset book-to-market ratios greater than one.
(ii) The relation is stronger for firms with weaker performance.
(iii) The relation is stronger for firms with a greater proportion of intangible assets.

Moreover, we find that several results from the efficient contracting literature appear to be explained by non-discretionary conservatism. Specifically, non-discretionary conservatism appears to subsume the results in prior research relating to debt-contracting incentives and to partially subsume the results in prior research relating to information asymmetry incentives. These findings suggest that non-discretionary conservatism plays a role in facilitating efficient contracting.

While our evidence is consistent with a significant role for non-discretionary conservatism, we emphasize two limitations of our findings. First, our model of non-discretionary conservative accounting explains only a small proportion of the observed variation in conservative accounting. This result is consistent with both limitations of our model to perfectly capture the circumstances under which GAAP requires asset write-downs and with the existence of significant discretionary conservatism.[3] We therefore emphasize that our results are consistent with the existence of significant discretionary conservatism. The contribution that we make with respect to previous research is in highlighting the role of non-discretionary conservatism in facilitating the efficient contracting documented by that research.

A second limitation of our findings is that our model of non-discretionary conservatism may inadvertently model discretionary conservatism. In other words, it could be the case that firms with impaired assets are not taking write-downs in response to GAAP, but in response to correlated omitted discretionary incentives. We have been unable to uncover any such incentives. One possibility that we considered was that firms with debt contracts could face incentives to take discretionary write-downs on impaired assets in order to appease debtholders. Inconsistent with this explanation, we find that our model of non-discretionary conservatism identifies write-downs of similar magnitude in firms without debt financing.

Our paper relates to several streams of existing research. First, it extends the extant literature on the determinants of write-downs (e.g., Strong and Meyer, 1987; Elliott and Shaw, 1988; Elliott and Hanna, 1996; Francis et al., 1996; Rees et al., 1996; Riedl, 2004). These prior studies generally concluded that material write-downs were discretionary 'big baths', as there was limited specific authoritative guidance on the accounting for asset impairments prior to 1995. Following the release of SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of (Financial Accounting Standards Board (FASB), 1995), GAAP for asset write-downs have been formalized. We use GAAP's authoritative guidance to model the determinants of non-discretionary write-downs. Our evidence suggests that a significant proportion of material write-downs can be explained by our model of non-discretionary write-downs.

Another line of prior research investigates the timing of write-downs. Most notably, Ramanna and Watts (2012) document a positive association between book-to-market ratios greater than one and incentives to avoid asset write-downs. They conclude that the managers of such firms exercise discretion to delay write-downs that are required by GAAP.[4]

[2] As with all of FASB's standards, impairment standards need not be applied to immaterial items. FASB's conceptual framework (Financial Accounting Standards Board (FASB), 2010) states that an item is material "if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity."

[3] The limitations of our model are illustrated by the Securities and Exchange Commission's challenge to Barnes & Noble's position that its goodwill was not impaired "despite operating losses during those periods and the significant difference between market capitalization and stockholders' equity at the evaluation date." (The Wall Street Journal CFO Report (WSJ), 2012) Even though a GAAP-mandated write-down appeared to be warranted, Barnes & Noble was able to defend its position by arguing that "our total market capitalization does not indicate the long-term fair value of the company." What is not clear is whether Barnes and Noble's position was motivated by managerial incentives to avoid a write-down or by a superior managerial assessment of fair value.

[4] Ramanna and Watts (2012) focus on how managerial incentives influence goodwill impairments under SFAS No. 142 (Financial Accounting Standards Board (FASB), 2001a). Our study provides a more general model for non-discretionary asset write-downs and uses the model to re-examine several previous studies. Nevertheless, both studies recognize the importance of GAAP as a determinant of write-downs.

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